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WHY CEOS FEAR THE '90S

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BUSINESS MONTH

SOLE MAN

PAUL FIREMAN'S STRUGGLE TO KEEP REEBOK ON TOP

By John Sedgwick

BUSINESS MONTH

JANUARY 1989

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COVER PHOTOGRAPH: TIMOTHY WHITE/CORPIX

FROM THE EDITOR IN CHIEF

The dust settles and there is silence in the land, as if the choir had sent its final note soaring and we now await our preppy good pastor. Reverend Bush, Big Business has settled in to listen.

How troubling it is that Big Business has been waiting so long. For the whole of the sophomoric and therefore boring campaign (in which each party sent the least of its candidates forth, and each of those candidates managed to find a running mate of even less fiber), business has wanted to hear just one thing, truly: What plans have you, dear Pastor, to ease the federal budget deficit?

The answer you have given, as near as the men and women directing the great corporations of this country can determine, is: none. They are angry, or at least the 25 or perhaps 30 to whom we have spoken are. And they feel no little betrayed. Their anger and deep worry is shared by the great many more CEOs who participated in this issue's survey by Yankelovich Clancy Shulman. Disturbed as they were by your choice of a Vice President (one CEO of an astonishingly large Midwestern corporation said: "That was stupid; that little man is an idiot, and it's enough to make me vote for Dukakis—but I didn't"), they stood by you. They believed and, most certainly, still believe, in very general terms, that you stand for things they hold dear, such as free enterprise, less government, strong defense, cutbacks in social programs—the American/Charlie Wilson virtues.

Everyone applauded Alan Greenspan, who said recently and publicly that something has to be done. Greenspan really lays it on the line. But he's not one of yours. It has been reported that business is happy that Nicholas Brady is staying on, but such glee is not universal. Another CEO, from a natty corporation just west of the Midwest, said: "Who cares about Brady? He was part of the last administration that didn't do anything about it [the deficit]."

All are aware of your tiptoeing through the campaign in this and nearly every other matter. You spoke of tax *cuts*, of all bizarre notions, in several areas, which included: capital gains, a sort of centerpiece of the program; a child-care tax credit; various breaks for the oil and gas industry that would reduce governmental revenues; breaks for companies that would put more into research and development. Beyond these there were frequent vague references to a "flexible freeze" in spending. Applause, applause. Businessmen like all the breaks they can get. But they wait. They await the pastoral message in the silence when the choir's echo has died. What they might do in their own companies hasn't much bearing on the federal deficit. But to a man, or person—there were several women, too—they said the dumbest remark of the long campaign was your braying insistence that taxes would not be raised. One CEO, whose company holds lots of government contracts, said: "He'll have to call it something else then, make up one of those loony government euphemisms. But he'll have to do it." This theme was echoed throughout BUSINESS MONTH's travels. It is inescapable and you must know it, and so must your followers. The deficit must be reduced, and specific sizable, responsible and humane cuts must be made in spending.

Most important, and this comes from the very cream of the crop of the Americans you most admire, is the matter of taxes and their increases. Before you speak to us this morning, consider the views of the lieutenants of industry (the era of the captains is perhaps returning, but not yet here), who are profoundly worried about the deficit and who look to you to lead us from this wilderness.

Before you speak, sir, read our fingertips: Taxes will have to be raised.

JOHN VAN DOORN

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NORA FELLER

What does the Salinas administration gain from airing the volatile issue of foreign investment? "Mexico would rather have investors than creditors," says Carlos Rojas, an American businessman who keeps in close touch with many Mexican companies. Though there is still no legislation moving through the Mexican Congress, the guessing is that the rules will be liberalized this year. Besides, as one Mexican businessman put it, "The bureaucracy makes the law." And right now it is moving inexorably toward opening up Mexico to foreign investors. —*P.B.F.*

High Hidden Costs of Globalization

AS THE TREND TOWARD GLOBALIZATION CONTINues and companies find themselves operating in an increasingly integrated world economy, they will face greater competition for talented executives. As a result, says Robin Holloway, managing director of Towers Perrin Foster & Crosby, an international management-consulting firm, "They must be prepared to offer total compensation packages—including incentive payments, benefits and perquisites—that are tax effective and competitive wherever they do business." According to a study conducted by TPF&C, which analyzed executive compensation in industrialized countries around the world, most companies ($100 million and over) do offer a variety of options for their chief executives. However, T. Boone Pickens's complaints notwithstanding, U.S. companies provide the only significant opportunities for long-term incentives, or stock-option plans. The following chart breaks down the total compensation for chief executives in a sampling of industrialized countries.

CHART BY NINA WALLACE

Possible Trend: Sue Defectors

HAS MANAGEMENT found a way to stop valuable employees from saying the words every American believes are his god-given right: "You can take this very lucrative position I single-handedly developed and shove it"? The verdict is still out, but a series of pivotal cases have certainly dampened the entrepreneurial spirit.

In late October, Arthur Andersen & Company, the Chicago-based big eight accounting firm, sued the giant advertising conglomerate Saatchi & Saatchi & Company and several former Andersen executives for conspiring to destroy the firm's management-consulting business. Andersen claims that employees who were planning to go to Saatchi & Saatchi tried—while they were still on the accounting firm's payroll—to persuade some of their clients to go with them.

That suit came hot on the heels of similar actions by another big eight Chicago firm, Arthur Young & Company, and London's WPP Group TLC. Arthur Young's charges are similar to Andersen's: Employees were leaving its consulting unit and tried to take part of the business with them. WPP sued to prevent a team of senior executives who left Lord, Geller, Federico & Einstein, a relatively independent advertising subsidiary, from starting another agency. WPP argues that a noncompete agreement signed in 1974 when J. Walter Thompson bought Lord, Geller remained in force after WPP bought J. Walter Thompson in 1987.

"No question about it," says Michael Epstein, a partner at Weil, Gotshal & Manges, a New York law firm that has a new division specializing in just such cases. "Companies are more willing to take legal action to protect their competitive positions." And since the courts have ruled increasingly for the employers who allege a need to protect their "investments" in employees, the suits are likely to continue. Thus, although a court can't prevent an employee from leaving and taking his skills with him, it can forbid him from soliciting former clients and from using specific techniques that were, presumably, developed at his old firm. Unfortunately, these are the two most valuable assets he can take to his nascent business.

Still, drawing the line between skills and employer-protected techniques isn't easy, and even in clear-cut cases, employers don't always score a victory. WPP did win an order blocking its former employees from soliciting its clients, but the judge took so long to come to a decision that by the time he signed the order, most of the clients had already flown the coop.

—*HOPE LAMPERT*

> **"IT IS ALMOST INCOMprehensible that so few American engineers speak and write Japanese. A worthy goal would be for them to learn Japanese as a second language. The continued failure to do this will almost surely deny us a large body of important technology."**
>
> *Norman R. Augustine, Chairman and Chief Executive, Martin Marietta, in a speech to Rensselaer Polytechnic Institute, Troy, New York, September 23, 1988*

HIGH ANXIETY

The economy keeps chugging, and the Reagan legacy survives. But the 609 CEOs in our second annual survey are anything but sanguine as they look to the 1990s.

BY STEPHEN W. QUICKEL

WHERE'S THE CHAMpagne? Where are the funny hats? Chief executives would seem to have a lot to celebrate. Business, even after six lush years, is still gaining. Inflation is low. Interest rates are reasonable. Trustbusters and union firebrands have scattered to parts unknown. And now a Republican (and former CEO) is in the White House for four more years. What more could a captain of industry want?

Plenty, it appears. To judge from their responses to BUSINESS MONTH's second annual CEO survey, top corporate managers are in a singularly somber mood. And our researchers didn't have to look hard to find the reasons. The big downer, of course, is the $155 billion federal trade deficit, which hangs like a Damoclean sword over the economy and the prepubescent Bush administration. A close second is the negative trade balance, which seems, like a mutant bacterium, to resist treatment. To no less than four-fifths of the 609 CEOs participating in the survey, the budget and trade gaps are the most serious threats facing U.S. business. As business leaders realize, the deficits could at the very least touch off major tax increases or send interest rates soaring. At worst, they threaten to undermine U.S. industry's struggle for competitiveness in world markets and deepen the nation's descent into creditor status.

But that's hardly the only reason top executives aren't uncorking the Dom Perignon these days. While most of them believe there will be no recession in 1989, that seems to be where their optimism ends. They know how fuzzy the economic picture really is, with government projections shifting constantly. And everywhere they look, they see other knotty and, often, worsening problems for business.

CEOs are, of course, uniquely positioned to view the major economic and business issues bedeviling the nation. To get a detailed overview of their thinking, BUSINESS MONTH last year commissioned the marketing research firm of Yankelovich Clancy Shulman to conduct the most comprehensive survey of top management opinion ever taken. The results were published in our January 1988 issue. To update the study, Yankelovich once again sent teams of researchers into the field to interview the heads of a wide variety of companies. The results of this survey are analyzed in depth over the next 10 pages.

Certainly, the CEOs are a lot more worried than they were a year ago. Seven of 10 now consider soaring employee-benefit costs a serious threat to business, versus just 27 percent a year ago. Six of 10 call government regulation and the quality of the U.S. work force serious threats, about twice as many as last year. And 63 percent say toxic-waste control is a serious threat, versus only 19 percent a year ago.

As for the budget deficit, they are obviously losing patience with the government's handling of the problem. Says one: "We need a clear signal—and soon—that Washington is getting its financial house in order." Says another, "If the government cannot maintain financial stability, it only encourages consumers and businesses to spend and borrow recklessly, too."

When it comes to remedies to bring

Stephen W. Quickel is a contributing editor of BUSINESS MONTH.

BEHIND THE STUDY

Our objective in commissioning the poll was to create a profile of chief executives' attitudes about the challenges facing American business in general and their companies in particular. From August 3 to September 28 of last year, interviewers from the marketing research firm of Yankelovich Clancy Shulman met with 609 chief executives. During hour-long discussions, the executives were asked 44 questions.

The bulk of the questions were aimed at measuring corporate leaders' opinions on a wide range of economic and business issues. In addition, the CEOs were asked a number of open-ended questions to elicit a more detailed explanation of their views.

Yankelovich chose the sample group from a list of 3,500 companies with at least $50 million in revenues. The group included 253 chief executives of manufacturing companies and 356 chief executives of service companies. Of those, 236 managed companies with more than $300 million in revenues, 222 ran companies with $100 million to $300 million in revenues, and 151 headed companies with $50 million to $100 million in revenues.

Geographically, 52 percent of the companies were in the Northeast, 25 percent in the North Central region, 13 percent in the South and 10 percent in the West. Publicly held companies made up 54 percent of the sample, privately held companies 46 percent.

down the deficit, six out of 10 think that the new President and Congress should cut social spending. But half would also take the ax to defense spending. Needless to say, few CEOs favor increases in corporate or personal income taxes. But if more revenues are needed, 55 percent support the introduction of a value-added tax, an idea that has been gathering steam for the past few years.

Perhaps the most startling revelation in this year's poll is that only 35 percent of the executives feel "very confident" about the ability of U.S. companies to deal with the manifold problems facing them. To be sure, almost two-thirds are "very confident" that their own companies can meet the challenges. But confidence in their fellow CEOs and in themselves has deteriorated over the past year.

Their harshest criticism is reserved for industry's global competitiveness. Companies cannot control the budget or trade deficits. But they can take steps to make themselves more formidable in foreign markets, and only 5 percent of the chief executives think that American companies are doing a good job in this crucial area. Says one: "By the time we decide to be part of the international scene, it may be too late."

No one knows better than a sitting CEO how difficult it is to come from behind and penetrate new markets, especially in distant nations, where American businessmen are only beginning to deal with the many cultural, language and political differences. Although a cheaper dollar has made U.S. exports more competitive during the past year, exchange-rate manipulation is only a stopgap measure. Nor is protectionist help from Washington the answer, although a number of executives want the government to move against countries that exclude American products. The only enduring solution, they agree, is for industry to produce the low-cost, high-quality products needed to compete and establish the global marketing strategies needed to sell them.

If American corporate leaders greet the new year worried and tense, that is perhaps a good thing. Rather than being lulled into complacency by six years of prosperity, they have been galvanized into sober reassessment by a kind of competitive shock therapy. And they know there are no short-term solutions. Looking ahead to the most important issues business will face a decade from now, the CEOs believe that the federal government will still be befuddled by budget deficits, that U.S. companies will still be struggling to adjust to a global marketplace, and that hiring and maintaining an adequate work force will be even tougher and more financially burdensome than it is today.

BUSINESS POLL MONTH

THE BUSH QUANDARY

They read his lips and voted for the Vice President, but CEOs doubt he can hold the line on taxes.

BY JEFFREY H. BIRNBAUM

AT THE END OF ALMOST every speech given by George Bush during his presidential drive, hundreds of balloons were released into the sky. The red-white-and-blue display made for great political theater, but, according to critics, it also supplied an apt metaphor for the entire Bush campaign: The incoming President's stands on the major economic issues were full of hot air.

Surprisingly, many of the nation's chief executives agreed. Sure, they overwhelmingly preferred Bush to Dukakis. But few really believed that their taxes would not rise and that the economy would not sink, even with their man in the White House. "We will see higher taxes and a mild recession no matter who is in office," said one chief executive.

The CEOs, 62 percent of whom are Republicans, favored Bush by a 10-to-one margin over Dukakis. An astounding 90 percent of them said it would be better for business if Bush were elected; a mere 3 percent thought business would have been better off with his Democratic rival. An overwhelming majority worried that if Dukakis had been elected, interest rates and inflation would have soared, and 58 percent predicted that a recession would have ensued—the only questions being how soon and how bad.

But this aversion to the Democrat probably had more to do with history than with the candidates themselves. Business simply did much better under the Reagan administration than it did under President Carter; accordingly, the CEOs backed the man who promised to be Reagan's heir.

■ Priorities for the new regime*:

Get tough on opening foreign markets 64%
Cut social spending 59%
Cut defense spending 51%
Tighten environmental rules 42%
Raise income taxes 35%
Product safety and liability 22%
Raise taxes on business 20%
Restrictions on takeovers 19%
Tougher antitrust actions 15%
*Multiple responses

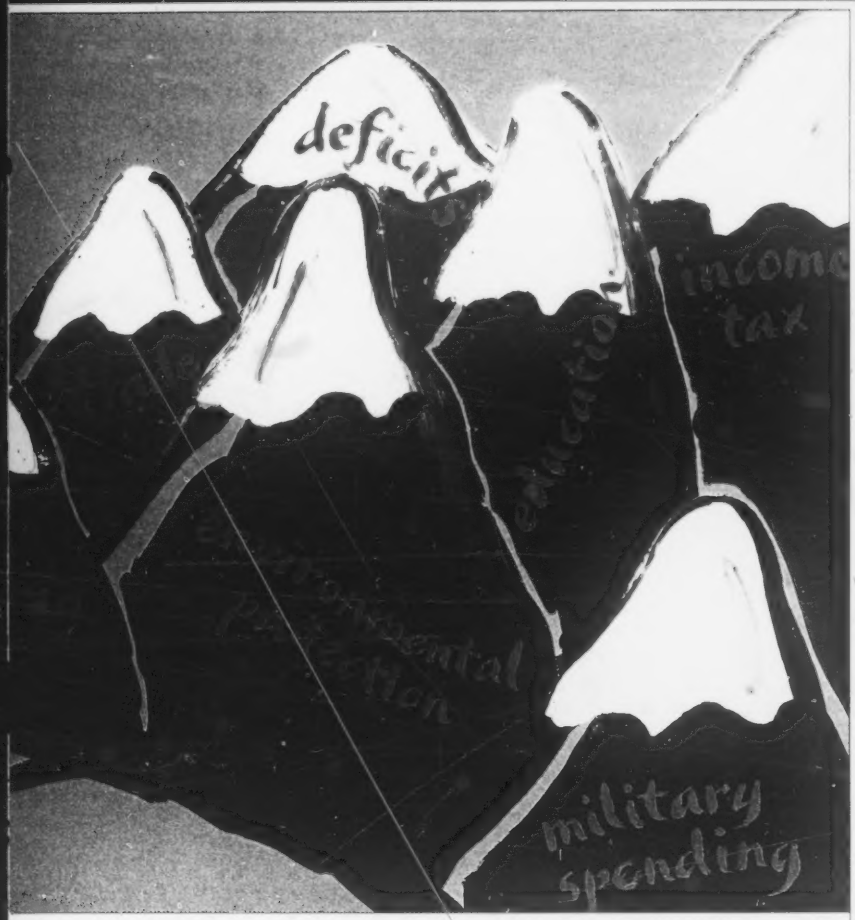
Almost with one voice the executives agreed that the Reagan policies of keeping taxes low and cutting spending have a better chance of continuing the six-year-old economic expansion than do the policies espoused by the Democrats. And on antitrust enforcement, federal health and safety regulations and a dozen other issues, they were persuaded of the former Vice President's desire to continue Reagan's policies of less government intrusiveness. Bush's actions and pronouncements since the election have done little to challenge that belief.

Of course, these opinions, expressed before November, were based more on faith than facts. Bush's rhetoric was purposefully vague throughout his campaign. As a result, even these staunch Bush supporters seemed somewhat skeptical. Many of the executives said that even a Bush presidency might not forestall the inevitable when faced with an economic downturn and the pressure to raise taxes. One-third said that a recession is still likely, and nearly two-fifths expected higher inflation and interest rates during the Bush years. And despite Bush's "read my lips" theatrics, 18 percent of the CEOs thought he would raise taxes on business in particular, and nearly one-quarter were convinced that he would raise income taxes in general.

But if Bush was murky on the issues and how to deal with them, the nation's top executives were not. Not surprisingly, the corporate leaders named the budget and trade deficits as enemies number one and two. "If we don't get those things under control," said one chief executive, "it will be harder and harder to do business."

Despite the vehement complaints about the dual deficits, however, the CEOs don't want to bear the burdens of a solution. Faced with the choice of higher taxes (which surely would hit businesses and high-earning individuals such as themselves) or lower social spending, the CEOs chose the spending side of the ledger by 59 percent to 35 percent. When asked specifi-

Jeffrey H. Birnbaum covered the Bush campaign for The Wall Street Journal.



cally whether they thought business taxes should be increased, a mere 21 percent volunteered to put their own balance sheets on the block.

Even when called on to decide what kind of taxes they preferred, the CEOs displayed a decided lack of egalitarianism. By two-to-one they said they liked best the levies that hurt them the least, but which fall disproportionately on lower-income individuals: sales and excise taxes. They disliked those levies that would hit them the hardest: income and corporate taxes.

While declining to make any sacrifices, the CEOs weren't shy about asking for Uncle Sam's help. Sixty-four percent of them said it is a main priority of the new President to take tougher action against countries that exclude American products. The corporate chieftains also hoped to avoid a step-up in federal regulation. A scant one-tenth thought that the next administration should bolster employee health and safety regulations or take stricter action against age and sex discrimination in the workplace.

One area in which the executives said they could countenance more spending was education—another score for Bush, who likes to call himself the "education President." There is, of course, a large self-serving element to this stance, since business has long complained about the inability of public schools to produce workers with the skills that are needed in today's economy.

Interestingly, the executives were more dovish than is their man on Pennsylvania Avenue. Half of those polled thought a main priority of the new administration should be cutting military spending to reduce the budget deficit, and only 26 percent were confident that such cuts would be made in the Bush administration.

Several said that they doubted that they ever could come out on the winning end of a government decision—even with a friend as President. "Politicians are interested only in getting votes," one disgruntled CEO concluded. "They are opposed to change beneficial to business." In short, nothing much is different.

ON GOVERNMENT:

- "Politicians overspend and don't control costs. Their way of balancing the budget is to increase taxes, and that's going to ruin the country."
- "The education system in the United States is not producing the quality people with the range of skills necessary to do the work."
- "The loss of confidence in business and government leaders is causing laws to be written that not only do not solve problems, but instead create new ones."
- "If we don't get the budget and trade deficits under control it will be harder and harder to do foreign business and will affect our domestic business."
- "There need to be fewer government restrictions on economic activity. Litigation increases the cost of doing business enormously. It weakens the ethical standards of companies and individuals and creates a mentality in business where people depend on intimidating legally."
- "It doesn't make any difference who is elected President. Congress is the policy-making body."
- "The government should subsidize certain exports the way other countries do to help develop markets."
- "The exchange-rate problem is probably one of the most difficult ones for American companies to deal with. The cycles of first dealing with a strong dollar and then a weak one is very difficult for all concerned. That's why we should return to the Bretton Woods system of fixed exchange rates."
- "Stable interest rates are vital because interest rates represent large costs for most businesses and affect long-term planning."
- "The reemergence of regulation—the plant-closing bill is a recent example—is the most important issue facing American business today."
- "Continuation of peace in the world would do more for worldwide prosperity than anything else."
- "I doubt that the power of the presidency means that much today."

STORM WARNING

Along with the budget and trade gaps, corporate debt is making top managers queasy.

BY MARC LEVINSON

AFTER SIX YEARS OF economic expansion, the chief executives whose investment decisions help determine business fluctuations see no downturn soon. Yet our survey detected unmistakable signs of unease. Even as they look forward to a profitable year, the businessmen fear that the bill will soon come due for the huge Reagan deficits. Says one chief executive, echoing the reproach of many of his colleagues: "Long-term financial stability is built around the government's ability to manage its economic affairs prudently."

Although only about one in 10 CEOs said a recession is very likely this year, almost half rate a recession as "somewhat likely." Expectations diverge sharply by region, however. In the South, where oil and gas remain depressed and the boom in textiles seems to be out of steam, two-thirds say a recession is imminent. In the West, where high technology plays a disproportionate role, only 41 percent take such a pessimistic view.

On Wall Street, the big action of late has been in blue-chip stocks, with the shares of smaller companies lagging. Yet the heads of firms with sales in the $50 million to $100 million range are notably more upbeat about the coming year than are their counterparts in giant corporations. Why the difference? It may be that only an optimist can run a smaller company. Then again, the people who manage such firms may simply have their ears closer to the ground. Whatever the case, theirs is not a blind optimism. Far more of those running companies with less than $100 million in sales say they have a plan for dealing with a recession than do the heads of the bigger companies.

■ Is a recession likely in 1989?
Very likely 11%
Somewhat likely 44%
Not likely at all 44%
Not sure 1%

■ Does your company have a plan for dealing with it?
Yes 61%
No 37%
Not sure 2%

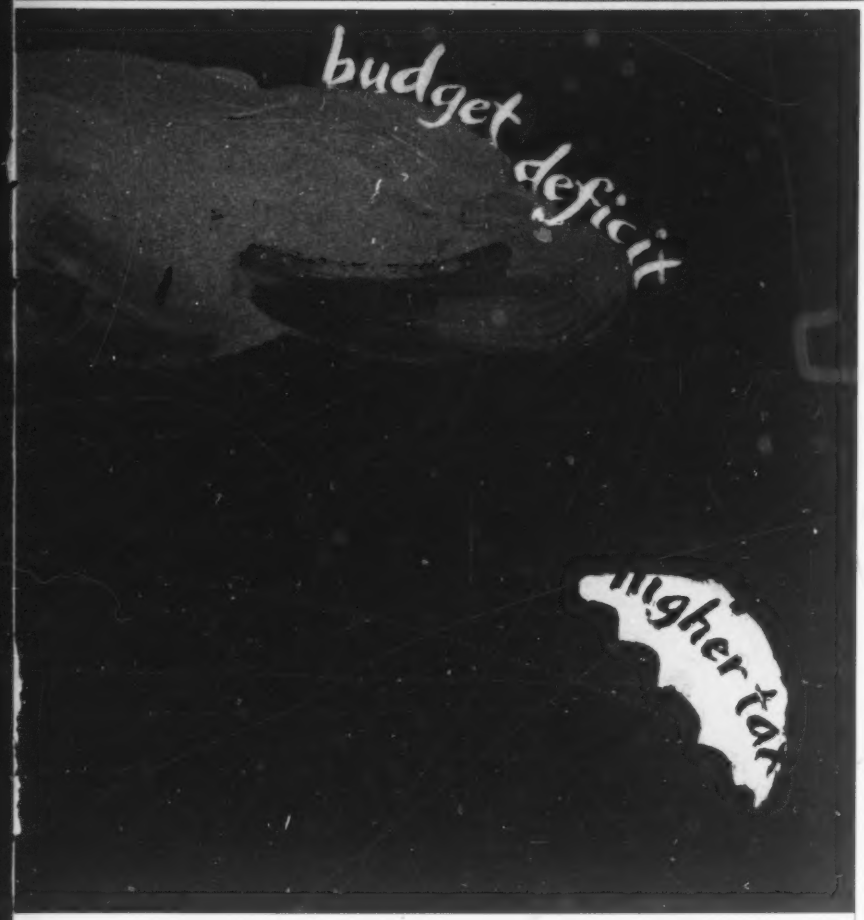
Corporate America is now seen as much leaner than it was before the 1981-82 downturn—and thus much readier to deal with a business crunch. Six out of 10 CEOs say their firms have plans for coping with a recession. "We would start making acquisitions," projects the head of a communications firm. "We're consistently cautious on loan quality," claims the chairman of a Northeastern bank. The chief executive of a manufacturing company states: "We want to make sure we are able to have our marketing team in place for years to come. If there's no sales, we don't need manufacturing plants."

Still, the basic strategies for dealing with a downturn remain unchanged: Cut workers and inventories. Despite intense concern over the availability of qualified workers in the years ahead, layoffs are still the key to many companies' recession plans. Respondents do not mention such alternatives as reducing work hours or instituting gain sharing (under which workers get greater job security by accepting part of their income as bonuses that can be reduced in down years).

The federal budget deficit is cited as the single greatest danger to prosperity. Four out of five CEOs say it is a "very serious" or "fairly serious" threat to business, while only 4 percent say it is not. Three years after Congress passed the Gramm-Rudman-Hollings Act to stem the deficits, the corporate chiefs say that the dire consequences of the budget shortfalls are undiminished. "The budget deficit will have a negative effect in the future, and we can't predict where or when and therefore can't manage for it," said one chief executive officer.

Inflation and interest rates, by contrast, do not emerge as burning worries in this year's survey. Perhaps executives, like other Americans, have come to accept inflation in the 4 percent to 5 percent range as normal. Then again, it may simply not be

Marc Levinson is editorial director of the Journal of Commerce.



a problem for many corporations: While CEOs speak of their continuing attention to cost control, very few report difficulty passing cost increases on to customers; this is in sharp contrast to the situation two or three years ago. Interest rates are, however, a source of worry for those who ponder the stability of a highly leveraged economy. "Enormous amounts of debts that have been acquired by corporations, individuals and governments have to be paid," says one. "If the world economy were to turn down, what would we do with all those debts?"

The CEOs believe overwhelmingly that manufacturing is on its way back: Three respondents in five say it will regain its position in the economy. Optimism is highest in the West, where 68 percent of the business leaders believe manufacturing is gaining in economic importance.

To propel that resurgence—and some 77 percent of the respondents believe it would matter "a lot" to the U.S. economy if manufacturing continued to decline—the chief executives stress research and development. They want changes in the tax laws to favor R&D, and they say Washington should revise the antitrust laws so that competitors may create research partnerships. The executives are far less enthusiastic about funneling more federal research grants to universities: While 49 percent think that is a good idea, 48 percent do not.

Heady optimism about the long-term health of the economy is noticeably absent from the executives' comments, and concern for the nation's fundamental economic strength is apparent. More than anything else, it appears, evidence that Congress and the new administration are attacking the budget deficit is needed to restore the sense that the economy is on a sound footing.

Yet, in the final analysis, the nation's corporate chief executives aren't that different from the rest of us. In overwhelming numbers, they recognize that higher taxes are needed to balance the budget. And in overwhelming numbers, they would like someone else to pay them.

ON THE ECONOMY:

- "We are being careful about our expenditures and our cost structure, and we're making sure we don't load in a lot of costs that will be difficult to take out if economic conditions get bad."
- "American business today is not investing in itself—too much money is spent on financial games."
- "If there is a recession, we will reorient our investment to higher-margin products, even if their long-term potential is less than some other products."
- "You create nothing with a service economy. You create no real wealth, and it makes you terribly dependent on someone else."
- "It's a question of whether or not we'll see the double coincidence of high inflation and poor business conditions."
- "Foreigners are converting their dollars into American industry. If they concentrate on specific industries, it could be serious."
- "I don't see how the world can absorb U.S. products if they are all in services."
- "Our competitive position has nothing to do with the quality of our products. Our problem is the value of our dollar versus foreign currency."
- "Continued growth of GNP, without inflation or recession, is essential to maintaining a strong business climate."
- "The deficit will never be resolved without tax increases for both individuals and businesses."
- "We have to spend time and energy understanding foreign markets and recognize the role quality plays in these markets."
- "We just can't seem to regain the edge we used to have in the world of management and technology."
- "There has been improvement in pride of workmanship. You can see it in the auto industry, the steel industry and in the machine-tool industry. But there are weaknesses in our education system. The urban systems are not turning out well-educated students. This will hurt us in the future."

BUSINESS POLL MONTH

AMERICA REDUX

Who says the country can't compete? Not CEOs, who say they are gaining on foreign rivals.

BY MARC LEVINSON

THIS IS CLEAR: THE FOREIGNERS who clobbered American companies in the 1970s and 1980s are not going to fade away in the coming decade. Sure, a weaker dollar will make U.S. products somewhat more competitive, and the Japanese, inspired by fears of a trade war, may tread with a little extra caution. But the Koreans and other Pacific Rim neighbors will become more aggressive, and after 1992, the European market may start to resemble a concrete bunker.

The question is, are U.S. companies up to the challenge? Few of the CEOs in our survey were wildly optimistic. As they see it, the United States is still being outclassed in the competitive race. An overwhelming 86 percent say Japan has the world's most competitive economy; West Germany and South Korea rank second and third. "U.S. industry is not nearly as efficient as industry in other parts of the world," said one executive.

Nevertheless, the business leaders share a strong belief that things may just be looking up for the United States. Nearly two-thirds said that U.S. companies are already gaining ground on their foreign competitors or will start doing so soon. Only one in five said that American companies will continue to lose ground.

The businessmen are ambivalent about foreign investment in the United States. While the sight of foreigners buying American real estate, securities and factories prompts little concern, there is a great deal of unease about the selling of the nation's companies. One executive in four said that legislation is needed to curb foreign takeovers. "Foreigners are converting their dollars into American industry," said one corporate chieftain. "If they concentrate on specific industries, it could be very serious."

■ Where do American companies stand globally?

Will continue to lose their market position to foreign competition 20%
Have reached a turning point and will soon be doing better 43%
Have already turned the corner and are gaining ground 21%
Will stay where they are now vis-à-vis foreign competition 13%
Not sure 3%

U.S. companies get a poor grade for the way they have adjusted to the globalization of the economy. Just 8 percent of CEOs said U.S. firms have done a good job of adjusting, and only 4 percent think American companies understand foreign markets and compete well in them. "The single most important issue facing us today is a slow, unwilling attitude toward international business," said the chairman of one company. "As business people we have not yet decided that we want to be a part of the international scene, whereas our competitors know they want to be part of the American scene."

But there is a striking difference between the doubts business leaders feel about American competitiveness and their satisfaction with their own companies. One in four says his firm is doing a good job of adjusting to globalization; only one in 10 admits it is doing poorly. But these assessments may be too self-congratulatory. Fully 40 percent said that understanding foreign markets is not important to their firms. Apparently, those whose companies do not compete overseas still do not realize that today's world market trends have a direct effect on almost every company's operations.

One example of that effect is likely to come from the European Community. With its 12 members' drive toward real economic integration, European companies will probably become larger and enjoy economies of scale that will make them tougher competitors on this side of the Atlantic. Yet only 15 percent of the chief executives say their companies have plans for dealing with a united Europe, and only 12 percent say their firms are developing such plans. Fully 46 percent have not addressed the issue, with service companies lagging well behind manufacturers. Companies that do no international business have ignored the implications of European integration almost entirely.

Those executives who have examined the issue, however, conclude that American companies will have a harder time competing in a Europe free of internal trade barriers. "Europe is going to become a real common market in 1992, and they are going to be more competitive," predicts one businessman. Another warns that "1992" may be the single most important issue now facing American business. "Everything is short-term in comparison," he says.

A surprising result of globalization is the resurgence of strategic planning, which in the cost-cutting decade of the 1980s many companies have either downgraded or simply eliminated. The focus on short-term earnings is giving way just enough to allow companies to think systematically about where they want to be five and even 10 years hence. Seven out of 10 chief executives said strategic planning will require a greater proportion of their time over the next two years. "We must do more strategic things to stay in competition," says one executive.

Deeply committed to the free-market, the executives now face a philosophical dilemma. Since the governments of America's competitors back their corporations to the hilt, the United States has little choice but to follow suit, the executives say—even if that means intervening in a free-market economy. In particular, they want the new administration to take tougher measures against countries that impose barriers to American exports. "The government has to insist on a level playing field," asserts one chief executive.

But even as they call for greater government assistance, many of the chief executives admit that the nation's difficulties in competing can be laid principally on the doorstep of business itself. "The biggest single issue, in my mind, is that we haven't returned to the original style of American business, that of being innovative," says one corporate chief. "If you go way back to the height of the Industrial Revolution, America stood out like a million dollars because everything we did was better than anyone else."

ON GLOBALIZATION:

■ "We must develop strong trading companies, as the Japanese have done. These trading companies would represent business in the international markets, offering banking and financial services as well as the documentation necessary for exports and imports."

■ "The third world will provide a huge opportunity for U.S. business. But first it must develop some buying power. But the potential is there, and we must position ourselves to take advantage of it."

■ "Don't build sewing machines in Kansas and try to sell them in Japan. We must put our operations where the market is. We must learn to operate in a global economy."

■ "We are undergoing a transition from companies that can compete within the U.S. economy and that may do some exporting to an environment where the entire world is one market."

■ "Japan, Korea and Taiwan compete on a worldwide basis. We are operating in the old mode and are at a competitive disadvantage by not acknowledging the major changes that have occurred."

■ "The world runs best if all people do what they can do best. If the Japanese can make cars better or for less money, that's okay. If America can provide phone service best, it should do it for the world."

■ "Europe is going to become a real common market in 1992, and they are going to be more competitive. But it is very much a government-controlled economy, which puts artificial constraints on American businesses."

■ "We must understand the culture as well as the nature of the market in a foreign country. American companies are so often unconcerned about other people and other nations that they alienate themselves."

■ "The management-labor relationship is being transformed from an adversarial type to one in which everyone is striving toward the same goal. I'm finding that middle managers and first-line managers and some of the hourly workers aren't used to that kind of approach. But when we create that kind of culture, we are going to be extremely competitive with the Japanese."

BUSINESS POLL MONTH

COMPANIES IN CRISIS

For planning, innovation and efficiency, top executives give their colleagues abysmal marks.

BY STEPHEN W. QUICKEL

DO AMERICAN CHIEF executives suffer from an inferiority complex? From a bad case of false modesty? Or are they simply telling it like it is? The questions come up because of the shockingly low marks CEOs give U.S. industry for operating performance. A mere 4 percent of those polled believe companies are doing a good job of competing in foreign markets, and just 6 percent think companies are doing a good job of planning for the future. Equally damning, only 14 percent give them a high rating for producing quality products and running efficient operations.

The CEOs are not much easier on themselves. When it comes to competing globally, only one in five believes his own company is performing well. Spelling out the reasons, fewer than half of the CEOs think their companies are doing a good job in three key areas: long-range planning, innovation and operating efficiency. And only one-third say they do a good job developing new products. They give themselves better grades for producing high-quality products; yet even here, only six out of 10 rate their performance "good." Can anyone seriously wonder why we have a huge trade deficit?

Twenty years ago, American CEOs might not have been so painfully honest. After all, U.S. companies were still the toast of the business world—the biggest, the richest and, supposedly, the best managed. Everyone said so, including the Japanese and European businessmen who visited the United States to find out how the Americans did it. That aura of invincibility vanished, of course, during the 1970s and 1980s, as hungrier, more resourceful foreign competitors exposed U.S. companies' outdated, inefficient operations, bloated payrolls, management inertia and other weaknesses. Only when the Americans began to be badly outsold in their own backyard by foreign rivals offering cheaper, higher-quality products did they take action.

■ **How do you rate the job U.S. companies are doing in planning for the future?**
Good 6% Fair 65%
Poor 28% Not sure 1%

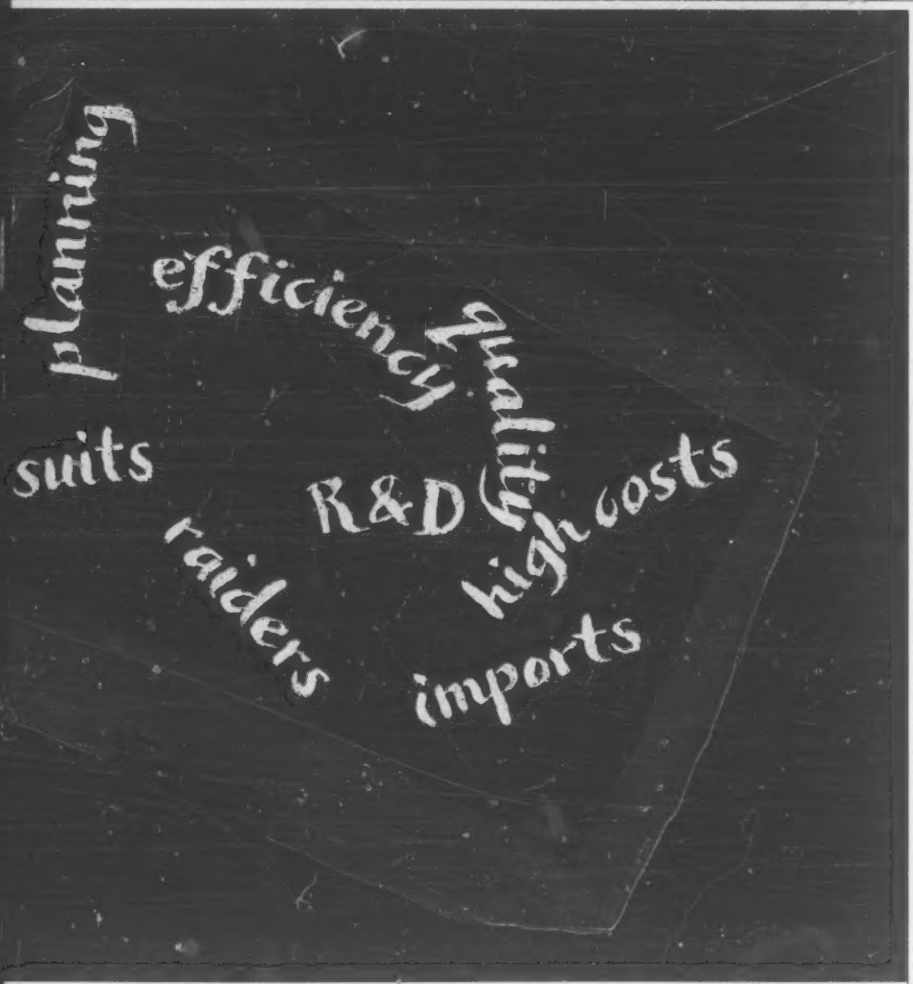
■ **Do you believe that American business is too short term-oriented?**
Yes 86% No 13%
Not sure 1%

By now, a decade of corporate restructuring, downsizing and modernization has begun to pay off in rising profits, improved productivity and new technological initiatives. And a number of companies have taken a lesson from their foreign rivals and fought back. Thus, Texas Instruments and Motorola, badly outhustled by Japanese rivals in one generation of semiconductors, learned how to regain the initiative by leapfrogging to the next generation. And Manville Corporation, realizing that its fiberglass technology was second-rate, swallowed its pride and licensed the foreign technology it needed to compete.

But these and other isolated success stories, the survey makes clear, are not nearly enough. By and large, corporate leaders simply don't believe that U.S. companies' decade-long struggle to create more competitive operations has been very successful. Indeed, only about half the CEOs whose companies have downsized say that they have increased market share as a result. And only 29 percent believe that takeovers and restructurings have helped the economy.

Why all the pessimism? One reason, and a dangerous and self-destructive one at that, is the pressure on companies to depart from carefully laid long-range plans in order to maximize near-term profits. While many are caught in this trap, most CEOs realize that letting Wall Street and corporate raiders call the tune is a mistake. A full 86 percent of those polled believe that business generally is too short term-oriented, and 40 percent admit that their own companies are.

A good way to tell where CEOs believe their major weaknesses lie is to find out where they plan to spend their time and money in the future. Two-thirds or more



of those polled say they will be concentrating over the next two years on three crucial areas to make their companies more competitive: strategic planning, cost control and marketing. Last year, fewer than half of the CEOs put these functions at the top of the list. More than two-fifths plan to pay more attention to quality control, double the number of a year ago.

Their spending plans likewise bear out these concerns. Some 62 percent of the CEOs say they will increase their marketing budgets next year, and about half plan to spend more for new-product development and introductions and to increase expenditures on plant and equipment.

Innovation in products and processes is, of course, critical to American competitiveness abroad, and right now the nation is generally perceived to be lagging behind—especially vis-à-vis Japan. Only 18 percent of the CEOs think U.S. companies are doing a good job in this vital area. And a mere 7 percent believe companies are investing enough money in R&D.

Nearly two-fifths of the CEOs plan bigger outlays for R&D over the next couple of years. But the cost of innovation is high, and this is one area where they want Washington's help. Four out of five favor changing the tax laws to provide R&D incentives for companies. More surprising, in light of American companies' well-known aversion to sharing technology, 90 percent want the antitrust laws changed so that companies can form partnerships to work on research and development. And about half of them think the government should funnel more research-and-development money to universities.

If one is to take corporate leaders at their word, then U.S. industry is not as prepared to confront the future as it should be. On the other hand, there seems little doubt that top management is more aware than ever of the nature and complexity of the job ahead—and, more important, of the high cost of failure. As one CEO puts it: "What happens in 10 years depends on what we do right now. We can wreck our companies' future if we don't make the right moves."

ON THE CORPORATION:

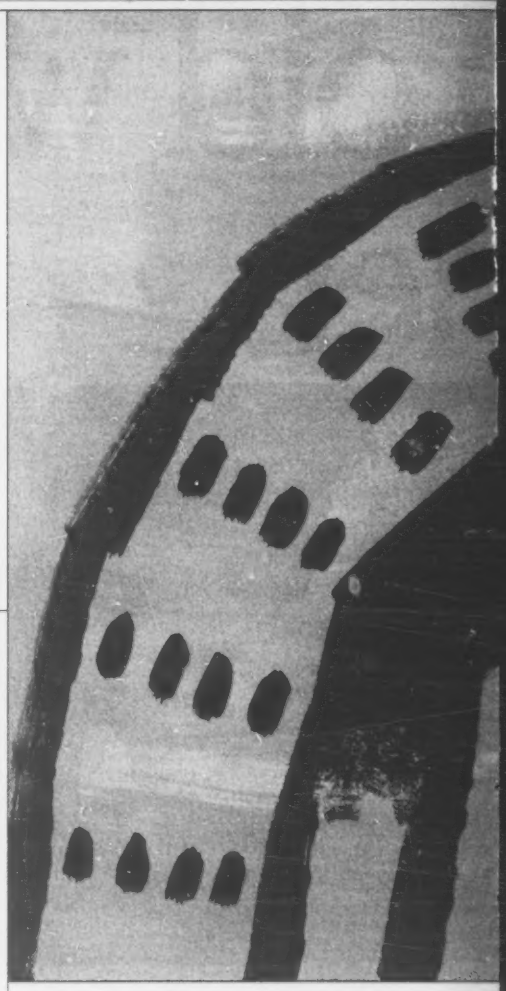
- "American companies do such a lousy job in productivity and customer service."
- "The management of a company is a complex recipe that has to be adjusted every day, every year."
- "To us, the quality process means really establishing and meeting customer requirements, analyzing and improving work processes and creating a sustaining, supportive work environment."
- "The issue is making our manufacturing more efficient. We must compete on a world scale with major industries."
- "Cost control touches so many things. Employee benefits, wages, taxes can go to hell in a hand basket."
- "We need people who can conceive an idea, then take it and make it work."
- "Most companies don't realize how uncompetitive they are internationally. Managers try to use other solutions, like legislation and tariffs, rather than working to improve their products."
- "We're pushing budgets and plans farther into the future and tying them to R&D to get where we want to be, instead of centering on where we have been."
- "American companies behave shortsightedly because of what they think the expectations of their investors are."
- "We have developed a new management responsibility level that handles the day-to-day business. That will allow the senior corporate officers to spend more time looking into the future."
- "The biggest challenge we face is finding highly educated, totally dedicated managers."
- "We have changed our executive compensation plan to emphasize long-term results rather than one-year performance."
- "Bureaucracy is our main problem—short-term bureaucratic thinking."
- "We have instituted a five-to-10-year operation plan. We now do our resource planning out to 15 years."

BUSINESS POLL MONTH

THE PEOPLE PLIGHT

As labor shortages threaten growth, companies are giving priority to employee relations.

BY THOMAS J. MURRAY



PITY THE POOR CHIEF executive come Judgment Day. What will he say when asked how well he took care of his employees? From the strike-busting tactics of the 1920s to the massive layoffs of the 1980s, American industry has demonstrated an almost timeless indifference to the concerns and aspirations of the millions of workers passing through its portals. As one chief executive interviewed for the BUSINESS MONTH survey puts it: "Employers have looked at employees as expendable resources for too long."

Yet hope is aborning. In the midst of a fast-changing business environment, a gradual sensitivity to employee needs is creeping into the executive suite. It is too soon to call it a revolution, or even the beginning of one. But cracks in the barriers that have separated the top from the bottom are definitely evident, as American management grapples with problems largely of its own making. Reflecting this changing attitude:

☐ More than half of the CEOs polled—versus less than one-quarter a year ago—list employee relations as one of the major activities they will be spending more time on over the next two years.

☐ More than two-thirds say that employee training and retraining is a pressing issue that requires the immediate attention of business.

☐ Just over 60 percent consider employee loyalty to the company a top-priority problem, and almost as many—57 percent—rate company loyalty to employees as a top priority.

Thomas J. Murray is a Los Angeles-based business writer.

■ How do you rate the job U.S. companies are doing in maintaining employee loyalty?

Good 7% Fair 51%
Poor 41% Not sure 1%

■ How does your firm rate in meeting the needs of employees with working spouses?

Good 15% Fair 51%
Poor 29% Does not apply 5%

Corporate restructurings and the dramatic shift to an information-based economy revealed the serious weaknesses in industry's training and retraining capabilities. As the U.S. manufacturing sector shrank in the early 1980s, and downsizing depleted middle-management ranks, companies were slow to recognize the need to upgrade the job skills of employees. Even now, relatively few companies have programs to tackle the immense challenge.

Clearly, management sees a people crunch ahead. Some 86 percent of the CEOs polled believe the quality of the U.S. work force is a serious threat to business. One says that the shortage of competent people, particularly at the entry level, "is probably our number-one problem."

Complicating the problem, an estimated 13 percent of U.S. job holders are functional or marginally functional illiterates. Although the blame for this disgrace lies primarily with the American school system, business bears the brunt of its effects.

The alienation of the work force has been a major setback for corporate America. Many top managers admit that they forfeited the loyalty of employees by the wholesale layoffs of the past decade, and they now acknowledge that loyalty is a two-way street requiring a long-term rebuilding campaign. Says one CEO: "We have not really developed the idea of a shared fate, that employees and employers are all in this together, and that what's good for the one is good for the other."

Some personnel experts doubt that the old-time trust can ever be restored. As they point out, a new generation entering the job market has no attachment to the cultural values of the white male population that has dominated the workplace. A mixture of blacks, Asians, Hispanics and other minorities will form a majority of the labor pool in the 1990s. These workers bring new and different work habits and expectations, and capturing their loyalty requires a major adjustment by management to allow for their cultural differences in establishing career paths.

That, of course, is not the only change in American society that has affected the workplace. Drug and alcohol abuse remain constant concerns of top management. Some 56 percent of the CEOs polled consider drugs a major problem requiring business' immediate attention; 44 percent list alcohol. The vast majority, 72 percent, have company policies to deal with these problems, but there is growing concern about how far companies can go. For one thing, in recent lawsuits attacking company drug-testing policies as an invasion of privacy, several key court decisions have come down on the side of employees.

AIDS is still not a big issue for management, but 57 percent of the CEOs expect it to become increasingly troublesome over the next few years. About one-third report that their companies have adopted policies toward employees who might have AIDS, versus only 14 percent last year. And more than two-thirds of the CEOs believe that companies should not be able to fire employees simply for having the disease.

One issue that has become a top priority for business is day care for the children of working mothers. Companies were slow to recognize the strains on the mothers who poured into the work force, but when personnel experts began to talk about such problems as excessive absenteeism and turnover rates, poor morale and lower productivity, they took action. By now companies are offering a variety of services, including on-premise day-care centers, financial assistance for outside child care, paid time off to care for new babies or sick children, and flexible working hours for mothers.

To be sure, CEOs are worried about paying for day-care, drug and alcohol programs, as they are about meeting the mushrooming costs of health care and other employee benefits. In fact, an overwhelming 94 percent of those polled believe that these costs are a serious threat to business. But it looks like a Catch-22 situation. As companies try to control benefit costs, one CEO notes ruefully, they will find it even more difficult to maintain the loyalty of their employees.

ON HUMAN RESOURCES:

- "We must make employees feel that they are part of the company and that they are striving with the company to generate a profit, produce quality products and keep customers satisfied."
- "American companies are not seriously concerned with human relations. That is the problem."
- "There is a tendency in many companies to accept good work as the norm and then criticize the rest. You have to really stroke and reinforce employees for work well done."
- "There should be better safeguards for the future. Retired people with fixed incomes are in jeopardy."
- "Companies have to integrate people into a corporate structure in which they can develop a lifetime career. We have to provide better training and show employees the potential that is available to them in the company."
- "The urban school systems are not turning out well-educated students. This will hurt us in the future."
- "Individual action will become increasingly important to business. We must create the structures and mind-set that make us comfortable with employee initiative and discretionary action."
- "We need the psychic and intellectual, as well as the physical, talent of employees. We must tap their ideas and values and input."
- "In the benefits area, we are not finding a common ground that meets employee expectations and is also fair to the company."
- "Companies have to learn to deal with employees who are speaking up for what they feel are their rights—such as better working conditions, relaxed dress codes and flexible work hours."
- "We are trying to involve more people in strategic management exercises—to extend them to lower-level employees."
- "Industry must make sure that the universities understand us better and build proper expectations in students. We do a better job with the older work force than with the young."

HOT FOR GLORY

Why slave for stockholders when you can have your own empire for 10 percent down? The answer, as these eager LBO managers learned, isn't always simple.

BY LEAH NATHANS

THE $17 BILLION BID BY F. Ross Johnson to take RJR Nabisco private brought leveraged buyouts out of the financial pages and onto the front page. But the real effect was to give LBOs overnight respect—as if Ivan Boesky had been awarded the Nobel Prize. Suddenly, CEOs across the country were seriously asking themselves: Would an LBO work for my company?

The appeal of LBOs to most executives is straightforward enough: power, glory and, especially, riches. Consider John Kluge, the chairman of Metromedia, who reportedly made $3 billion selling off pieces of his company, and investors in Dr Pepper, who cashed out with more than $600 million in the spring of 1988. Even a small deal, such as the $60 million buyout of the Bumble Bee Seafoods division of Castle & Cooke scored about $20 million for Patrick Rose, the head of Bumble Bee, who says with satisfaction, "I never have to worry about money, nor do my children, nor do their children."

There is also the emotional high of actually running one's own company. No more sending financial reports to a prying board of directors who show up four times a year. Instead, the LBO CEO works with a small group of seasoned managers and financial hotshots. Because all of them are owners, all—at least in theory—are motivated to make quick, smart and profitable decisions.

Having started modestly enough in the 1970s as bootstrap financing for small companies, LBOs have quickly grown into the high-powered deal of choice for the majors. In just the past three years, more than 500 companies went private in leveraged buyouts by management, by outside investors or by a combination of both. In the first nine months of 1988, 143 more LBOs—together worth a staggering $91 billion—were initiated, up from 92 LBOs worth $27.9 billion in 1987. An estimated $300 billion worth of companies now exist in a private LBO economy.

What sort of company is a good candidate for a leveraged buyout? A boring one. Lenders and managers prefer quiet and steady money-makers to exciting and cyclical companies that may have trouble meeting their onerous debt burdens. In fact, most LBOs—75 percent—involve buyouts of corporate divisions that are already doing well.

Certainly, all LBOs are risky. Some managers who lead buyouts find themselves selling or leveraging their houses, not to mention their stock options, to buy stock in their company. So far, few deals have gone broke, as has the buyout of the drugstore chain Revco D.S.—or have stopped repaying bank debt, as Republic Health has. "You can count on the fingers of one hand the number of busted deals," says George Baker, a professor of business administration at Harvard Business School. But the party could end quickly. If a recession in 1989 forces interest rates up and pushes operating income below what is needed to service a company's debt, managers risk losing not only their credibility but their investments and their jobs.

Caught between the attractions and the risks of LBOs, what's an entrepreneurial-leaning CEO to do? He might well take some clues from the following cases.

Leah Nathans is BUSINESS MONTH*'s senior writer.*

SWEAT, TERROR AND CANNED TUNA

PATRICK ROSE'S LBO OF Bumble Bee is the kind that gives buyouts a good name and stirs wistful daydreams in the minds of division executives. The hardworking president of the Bumble Bee tuna division at Castle & Cooke took the unit private, quickly turned it into a success as an independent company and then sold it to a conglomerate. Rose and three other manager-owners cashed out of Bumble Bee with a return of $80 for every $1 invested.

Bumble Bee was the perfect LBO candidate: a cash machine that had fallen on hard times. The canned-tuna industry may not be exciting, but it generates steady cash flow and needs little capital investment. In a virtual oligopoly, H.J. Heinz's Star-Kist, Ralston Purina's Chicken-of-the-Sea and Bumble Bee control 71 percent of the market. Still, back in 1980 Castle & Cooke, a real-estate developer and consumer-food producer, managed to bungle a sure thing by expanding capacity, buying the largest tuna-boat fleet in the industry and entering into expensive, long-term procurement contracts with tuna-boat operators. With costs up and the industry in a downturn, earnings plummeted. The division posted a loss of $2.6 million for 1980.

In an effort to turn things around, the company in 1981 hired Rose, then a Van Camp Seafood executive, as president of the division. Under his new management team, Bumble Bee lost $16.3 million in 1982. But in 1984 Rose's efforts paid off:

DAVID STRICK/ONYX

The division earned an impressive $7.3 million in profits. Castle & Cooke's management, though, was in no position to reward progress. Reeling under large net losses from its other businesses, the company had attracted the attention of the raider Irwin Jacobs and had to move fast to defend itself.

It didn't take long for Rose to figure out what management planned to do. While reading a management strategy memo, he noticed that it excluded any reference to the seafood business. The official announcement came in early 1984: To raise some quick cash, Bumble Bee was being put on the auction block. That's when Rose decided to bid for the division, which, he believed from hands-on experience, was a valuable franchise.

Castle & Cooke agreed to let Rose bid for Bumble Bee—if he also helped peddle the division to outside bidders. A number of competitors and leveraged buyout firms looked over Bumble Bee, but all expressed skepticism when Rose argued that the division was undervalued. "The bidders and Castle & Cooke grossly underestimated the potential of the business," he says.

In the spring of 1985, Jacobs had been bought off with greenmail, and Rose had won management's auction with an offer of $62.5 million. To structure the deal, Rose approached First Boston, an investment bank that was earning a reputation for its innovative LBO deals. First Boston was impressed. "We saw a management team with an attractive game plan that was excited about the potential," says Arthur Nagle, then co-manager of the firm's LBO department.

In June, the buyout, with backing from the Bank of Boston, finally went through. It was highly leveraged: only 5 percent equity—$3.3 million—and bank debt of $59.2 million. Bank of Boston put up $1 million of the equity, First Boston invested $1.2 million and the four Bumble Bee managers put up an unusually large 40 percent, or $1 million. For Rose, the transaction was both exhilarating and terrifying. "I was 43 years old and basically putting on the line what I had spent my life trying to accumulate," he says. "An LBO doesn't use a carrot as much as a stick. The incentive is not the pot of gold. It's the negative incentive of not falling into the dark pit." Adding to the pressure was a class-action suit filed by Castle & Cooke shareholders, who charged that Bumble Bee management had paid too little. (The suit was ultimately settled out of court for what Rose calls a modest amount.)

Rose took immediate action to make certain the buyout would work. He saved $9 million with three simple steps: He declined to buy Bumble Bee's expensive tuna fishing fleet and two unprofitable plants in Hawaii and San Diego. He got out of Castle & Cooke's expensive, long-term contracts with domestic fishermen (as a new legal entity, the company wasn't bound by previous contracts) and started buying tuna from cheaper Asian sources. And, following an industry trend, he cut the advertising budget in half.

Over the next few months Rose made additional changes. He increased the offshore cannery staff from 900 to 1,200 workers per shift. He trimmed 30 persons from the corporate payroll, leaving 111 employees. He automated office operations, increasing the number of PCs from three to 100, including a terminal in his office to give him a daily update on inventory. The result was that an office staff 25 percent smaller was soon handling more business than before. "More people were working in the cannery turning raw fish into canned fish, versus crunching paper in the office," says Rose.

To keep the loyalty of both employees and customers, Rose issued stock options to more than 30 managers and launched performance-based incentive plans for others and also stepped up major capital investment in Bumble Bee's cannery in Puerto Rico. Finally, Rose decided to move company headquarters from a dreary structure under a bridge on the San Diego waterfront to a new hilltop office building. "We needed to psychologically make a break from the past and send a signal that the term 'LBO' doesn't mean you don't have any money," explains Rose.

Success was instantaneous. In the first 29 weeks, Bumble Bee made $6 million. At the end of the fiscal year, Rose was able to pay down $8.2 million of bank debt to about $47.1 million, substantially ahead of schedule. Continuing to flourish, Bumble Bee earned more than $16 million in 1986 and in 1987 moved from the number-three tuna brand to the number-two brand.

BY LAST SPRING ROSE and his management team wondered whether the time wasn't ripe to cash in on Bumble Bee's run-up in value. They had intended all along to sell the company or go public within five years; they hadn't expected that they would be ready to do so in just three. Rose also felt that the company needed a richer owner, one who could afford to expand processing facilities and who would be willing to take more chances. "When you have 99 percent of your net worth tied up in the company, you start getting too careful," he says.

At a board meeting in Puerto Rico last April, Rose and his three managers reached a final decision to sell. There was no shortage of takers. In July Pillsbury agreed to buy the firm, if Rose would

FAST FACTS ABOUT LBOs

First billion-dollar LBO: Wometco Enterprises Inc. in 1984 ($1.1 billion)

Average premium over stock prices that LBO participants paid in 1988: 39.8 percent

Most successful LBO deal maker in 1985: First Boston, $36 million in fees

Most successful in 1988: Morgan Stanley, $62 million in fees

Single largest fee for doing an LBO in 1985: $11 million, earned by Dillion Read & Company for the Storer Communications deal

Single largest fee in 1988: $28 million, earned by Kohlberg, Kravis, Roberts & Company for Stop & Shop deal

Number of companies KKR has acquired so far: 35

Number of companies KKR still controls: 23

Pension fund believed to have the biggest investment in LBOs: State of Oregon's, $500 million

Average percentage of employees who lose their jobs in LBOs: 0 percent (according to a study of 30 recent leveraged buyouts by Steven Kaplan, a University of Chicago finance professor)

Percentage of LBO loans among all bank loans in 1988: 25 percent

Top bank in LBO loans: Citicorp, $21.5 billion since mid-1987

Bank with the most LBO loans outstanding: Citicorp, $4 billion

Average ratio of debt to equity in U.S. corporations: 0.65-to-1

Ratio of debt to equity in Revco LBO when the company went bankrupt last summer: 5-to-1

—Compiled by Fred F. Jespersen

1988 figures are for first three quarters only. Data: IDD Information Services and other sources

agree to stay on as chief executive for at least five years. The price was about $200 million—almost a 500 percent increase over what Rose and his team had paid three years before.

These phenomenal gains resulted not from fancy financial footwork but from good management combined with Rose's inside understanding of the company. Freed from stifling bureaucracy, spurred by debt, Rose and his managers turned Bumble Bee into an efficient and competitive firm. For Rose, it was a revelation. "There was an immense release of creativity and energy," he says.

Rose has mixed feelings about being part of a big corporation again. "I think I've been indelibly changed," he says. "I've grown up in large corporations and seen the waste and carelessness that creeps into the decision process" when executives have no personal stake in the company. "I still feel like I own [Bumble Bee]," he says. "I don't ever want to lose that." That's a feeling Rose may lose faster than he expected. Last October, the British food giant Grand Metropolitan made a hostile bid for Pillsbury. It was a reminder that in business today very little is predictable.

THE HIGH COST OF BLIND AMBITION

BUMBLE BEE WAS THE right LBO at the right time. Sometimes managers aren't so lucky. One deal that was jinxed before the ink was dry was the leveraged buyout of Republic Health, a Dallas-based chain of hospitals and clinics. It was a buyout that shouldn't have happened—doomed by overoptimistic projections of earnings, a misreading of the business climate and blind confidence in management. Serving no economic purpose except to enrich the deal makers, the LBO wound up jeopardizing the company's survival.

None of that was apparent in August 1986 when the $566 million buyout took Republic Health private. It was an especially big day for James E. Buncher, the chief executive of the company, who had worked on the deal for months. He was held in such high regard at Republic Health that scores of employees gathered to buy a stake in the company.

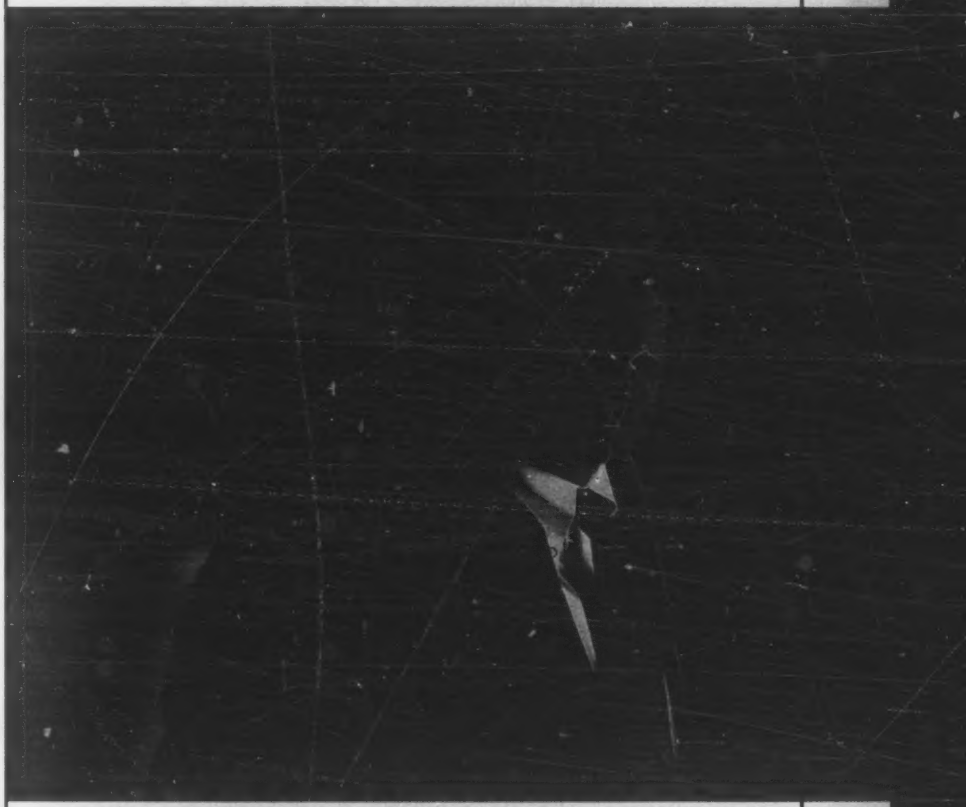
All were understandably optimistic about the venture. Business had been profitable, thanks in part to insurance company largess and the generous federal bounty of Medicare, but also to good management. Republic Health, formed in 1981, had quickly made a name for itself as a cost cutter and an aggressive and innovative marketer of services. Its rapid growth caught the eye of Dr. Leroy Pesch, a wealthy Chicago health-care magnate. In 1984, he merged Republic Health with his own publicly held company—Health Resources Corporation of America. But Pesch didn't stop there. Intent on building a health-care empire, he sought a vehicle he could control in order to expand more aggressively. Republic Health would give him that vehicle.

In early 1986, with the support of Buncher, Republic's longtime chief executive, Pesch set out to take the company private and discovered that getting financing was remarkably easy. The two hired the investment bank Donaldson, Lufkin & Jenrette, which quickly located a backer, Pacific Asset Holdings, a limited partnership with $1.2 billion in capital that is headed by Gary Winnick, a former lieutenant of Drexel Burnham Lambert's Michael Milken. Pacific Asset's investors included such heavyweight deal makers as Sid Richardson Bass, the Fort Worth investor. Surprisingly, these experienced investors didn't question Buncher and Pesch's rosy forecast that the hospital industry was going to continue growing as it had since the early 1980's.

By August, Buncher and Pesch's efforts had paid off and the deal was completed. Pacific Asset put up $200 million; Pesch, $34.3 million; and Donaldson, Lufkin & Jenrette, $4.3 million. Bank loans accounted for $265 million. Buncher himself, who had earned $3.8 million when Republic Health went private, put in $1.8 million.

In a vote of confidence in Buncher and Republic Health, some 125 employees—from managers to secretaries—committed a total of $6.2 million to the buyout, with stakes ranging from $1,000 to $1.8 million. Most put up cash for 25 percent and signed promissory notes for the rest. They were certain that Republic Health's rapid

"THE ORGANIZATION WAS PARALYZED,' SAYS MARSAL. 'ALL IT COULD DO WAS LIVE FROM ONE DAY TO THE NEXT.'



To revive ailing Republic Health, Bryan Marsal halted debt repayment on the LBO.

STEVEN PUMPHREY

rise would continue, especially with Buncher in charge. "The main reason I signed on was because I believed in Jim Buncher," says Ken Teel, a Republic hospital administrator. But the company that had been so promising before was now carrying a total debt of $430 million. In just the first year Buncher was facing interest payments of $99 million, though cash flow was only $84 million. The underlying problem became agonizingly clear in retrospect: Pesch and Buncher had paid too much for Republic Health. The deal had been done when health-care price/earnings multiples were at a peak.

To make matters worse, the patient population was showing signs of declining, and the federal government had just restricted its generous Medicare payments. Instead of continuing to grow in 1987 as expected, the entire industry appeared to be heading into a serious downturn.

To keep the banks—and bankruptcy—at bay, Buncher found he had no choice but to siphon money out of the hospitals' coffers. He cut capital expenditures by 60 percent. Doctors started leaving the hospitals because administrators were postponing the purchase of new equipment. Staff turnover among controllers grew to 80 percent. Vendors delivered medical supplies only by COD because the hospitals were waiting as long as 180 days before paying their bills. Employees stopped traveling on essential business trips because they weren't sure when they would get reimbursement checks.

Buncher was now in the hot seat. The company-wide confidence he had enjoyed earlier began to evaporate. The tension increased. "People who used to be real friendly weren't friendly anymore," says Teel. Finally, in June 1987, under pressure from Pesch, the board hired Drexel Burnham Lambert to assess the state of the company. Drexel brought in Bryan Marsal, a New York turnaround expert, who spent two weeks visiting 20 Republic-owned hospitals across the country. He walked the halls, talking to doctors, nurses, administrators and controllers.

A grim picture emerged. Marsal was shocked to find that a financial quagmire had transformed a healthy company into an invalid. Patient care was in danger of being compromised. "The organization was paralyzed," says Marsal, who is the president of Alvarez & Marsal, a turnaround firm in New York. It was producing a lot of cash, but "all it could do was live from one day to the next."

Meeting with the board, whose seven members included Pesch, Buncher and Pacific Asset, and representatives of Donaldson, Lufkin & Jenrette, Marsal was blunt: The company could not continue to pay the banks and maintain acceptable hospitals at the same time. "We told the board, 'You will get money out for only three more months, and then you will get no money because you have injured the franchise,' " says Marsal's partner, Antonio C. Alvarez II.

Buncher sought to rebut Marsal's assessment. But galvanized by the searing report, the rest of the board voted Buncher out and installed Marsal as interim chief executive. His first decision was to declare a moratorium on the repayment of bank debt. "It was a gut-wrenching decision to say, months into the LBO, 'By the way folks, I can't pay you,' " Marsal recalls. He channeled the money directly into the hospitals, more than doubling capital spending to $14.6 million, and hired more controllers, administrators and nurses. He sold unprofitable hospitals. To attract and retain top doctors, Marsal also set up five joint ventures that allowed doctors to become part owners of hospitals and to have some say in managing their facilities. With loss down from $283 million to $71 million, the company is slowly getting back on its feet.

Marsal's goal is to complete what he calls "a reversal of the LBO." He has been seeking the creditors' approval of a debt-for-equity exchange offer that would bring the debt level down from $800 million to $415 million, about the level before the buyout, and would reduce interest payments from $91.4 million to $44 million. Junk-bond holders would assume control of the company and recover their investment only if Republic Health continues to improve. The banks would be paid in full, but in five years instead of 15 months. The big losers would be the holders of the common and preferred stock, whose investment would be virtually wiped out—namely Pesch, Buncher and the 125 Republic Health employees. None of the creditors likes the plan, but because it keeps Republic out of bankruptcy, it faces a good chance of approval.

Though they praise Marsal, the operating managers who invested in the buyout are bitter about losing money and say top Republic management mislead them. Especially angry are the managers who are still bound by promissory notes that forbid them to leave the company until they settle up as much as $200,000 in debt. "I feel like an indentured servant," says one manager who is about $100,000 in hock.

Others, though, landed more comfortably. Buncher may wind up losing his investment in the buyout, but he will continue to draw an annual salary of $400,000 until 1991. ("It's a contract I am forced to honor," says Marsal. "What can we do, sue him for bad judgment?") Meanwhile, Buncher has started up a small venture-capital business in Plano, Texas. Gary Winnick, the head of Pacific Asset, will come out about even. Marsal & Alvarez has earned fees of $1.7 million so far. Donaldson, Lufkin & Jenrette earned $1.1 million, and Drexel, $4.4 million. Perhaps the biggest winners, though, were the stockholders who bailed out of the deal at $19 a share when the company went private.

REORGANIZING FOR PAIN AND PROFIT

SHAREHOLDERS ARE ALSO the big winners in another kind of LBO, the mega-deals that involve the breakup of healthy companies. Such buyouts are often a way for CEOs to avoid takeovers, stay in control and disassemble their companies themselves rather than wait for raiders to do it. Although it is painful for managers and other employees caught in the middle, such buyouts, by forcing a reappraisal of a company's objectives and operations, can produce a healthier operation.

In 1987 Borg-Warner, facing a takeover threat, was one company that needed the cataclysmic event of an LBO to restructure. It got one through Merrill Lynch Capital Partners, which took the Chicago-based company private that year and, to make certain the buyout succeeded, installed James F. Beré as chief executive. A pillar of the Chicago business establishment, Beré was no stranger to Borg-Warner. He had been its president for 14 years, until he chose semi-retirement in April 1986, though he continued as chairman. In fact, it was Beré's success in building up Borg-Warner to $3.4 billion in sales that had made it an attractive takeover target in the first place.

During his tenure, Beré had diversified Borg-Warner away from its core business, a venerable automotive division that supplied the big three automakers with most of their brakes and transmissions. He aggressively built a finance company, bought a credit-reporting company to complement it, and entered the security business with the purchase of Baker Industries, which furnished armored-transport services under the Wells Fargo name.

Borg-Warner became an attractive takeover target: a company with little debt trading for less than the value of its unrelated businesses. In late 1986, the raiders Irwin Jacobs and Samuel Heyman notified the Securities and Exchange Commission that they had bought stakes in Borg-Warner; each controlled about 10 percent of the company's stock, worth a total of $680 million.

Alarmed, Borg-Warner's board of di-

WITH A $725 MILLION LOAN PAYMENT COMING DUE, BERÉ FELT AS THOUGH 'A HUGE WAVE WOULD ENVELOP ME.'

CEO James Beré foiled raiders by presiding over the breakup of Borg-Warner.

PAUL ELLEDGE

rectors hastily decided that its best defense was to take the company private. The directors turned to Merrill Lynch Capital Partners, a $1.5 billion LBO fund, to structure a deal using loan commitments from commercial banks. The plan was to offer stockholders $43 a share. But as soon as they recovered from their initial apprehension, the directors had a change of heart. "Their attitude was, we're Borg-Warner, one of the biggest companies in the country, and nothing is going to happen to us," says James J. Burke Jr., head of the Merrill Lynch subsidiary. Burke had a different take on the situation. He was so certain Borg-Warner would need help soon that Merrill Lynch paid the banks $350,000 in commitment fees to keep the LBO loans warm. Burke was right. In March 1987, Heyman bought Jacobs's shares and made a $46-a-share hostile tender offer for Borg-Warner. Chastened, the directors rehired Merrill Lynch.

Their waffling was costly. To top Heyman's bid meant putting together a more expensive deal. In May 1987 Merrill Lynch paid $4.4 billion for the buyout. Banks lent $3.4 billion, and $1 billion was later raised in a junk-bond offering. Merrill Lynch put up $101 million for a 51 percent controlling interest, outside investors contributed $79 million, and about 82 Borg-Warner managers bought 10 percent—or $20 million—of the equity. With a bigger deal in place, there would now be no choice but to break up Borg-Warner and use the money to pay down the debt.

Beré, who had acquired a $5 million equity interest with money from the sale of his Borg-Warner shares, was to preside over the breakup. Returning as CEO meant a considerable adjustment for him. He faced an activist board—six directors, including four Merrill Lynch partners, with a direct stake in Borg-Warner's future. Beré calls the day-to-day shots, but the board sets strategy. And Beré, who is 65, reports to Burke, who is only 37.

As he took his post in July, one question loomed for Beré: How much could he get for selling the company's divisions? By the end of the year $725 million was due on the debt that had been incurred, and $1.8 billion more was due by the end of 1988. He had to move fast. "For the first time," Beré recalls, "I had to operate as if a huge wave would envelop me, even though I was working at my optimum."

Indeed, a wave almost did envelop him—the stock-market crash, an event that nearly sank his company's debt-laden ship. Black Monday endangered the sale of Borg-Warner Acceptance Corporation, the finance subsidiary that Beré had built from scratch and that contributed 20 percent of the company's earnings. Even more serious, the market crash dealt a severe blow to Beré's chances of getting a good price for the West Virginia-based chemical and plastics division, the world's leading producer of the raw plastic used in telephones and computers. The crash knocked the price/earnings multiples of chemical companies from about 20 to a measly 10, cutting in half what Beré had expected to get for the division.

As the market struggled back so did Beré's hopes. By the end of 1987, the sale of Borg-Warner Acceptance Corporation to TransAmerica had been consummated for $782.5 million. By last June, chemical multiples had recovered, and General Electric had stepped in to buy the chemical and plastics division for the healthy price of $2.3 billion.

The two sales, together with the sale of an industrial-products division and an Australian subsidiary, more than covered the $2.5 billion debt payment due at the end of the year. "There was a tremendous release of emotions because we had made the goal," says Beré. "It was a very important milestone."

Meanwhile, Beré was moving quickly to bolster earnings. He slashed the corporate staff from 235 to 120 and trimmed the number of officers from 21 to 11. Among the posts he cut: vice chairman and president. "It's not that we were fat or lazy before," says Patricia Yoxall, the only remaining member of the company's communications office, which had a staff of 14. "We just found out how much we could achieve when we were forced to."

Beré also cut $3 million from the 1988 research-and-development budget, a decision he defends by arguing that the remaining money is being spent more productively. Instead of funding 10 new areas in the hope that one would pan out, the company has upped its spending by 20 percent in the five most promising areas—including continuous variable transmis-

sions. "We stopped kidding ourselves with things like fuel-injection engines," says Donald C. Trauscht, Borg-Warner's vice president of finance and corporate strategy. "We put more coal in stoking the businesses we were in."

Borg-Warner looks like a different company today from the one Beré ran just a few years ago. But the results, due partly to his management and a strong economy, are impressive. The company, now only in the automotive and security businesses, has sales of $2.1 billion. By cutting overhead and money-losing operations, Beré has raised earnings by 10 percent. He's brought the debt-to-equity ratio from 22-to-one at the outset of the LBO down to two-to-one.

All in all, the buyout of Borg-Warner was a bittersweet experience for Beré. "It was difficult to know the whole company was up for sale," he says. "These are the seeds you planted 20 years ago and prayed for rain for, the patient work of a whole career that now must meet short-term objectives. We had to adjust emotionally." At the same time, he takes satisfaction in knowing that he has found good homes for the divested divisions, that cash flow is at a healthy level and that inventory management has improved substantially, even if the company stocks fewer items. But he is still no flaming advocate of LBOs. "Time will tell whether they are good," he says.

Beré acknowledges that he learned unexpected lessons. "I thought debt was sinful," he says. "I think I was mistaken. Today, a debt-to-equity ratio of 20 percent is as obsolete as the Model T." He has also become a convert to the motivational magic of ownership. When managers had no stake in Borg-Warner, Beré says, they nodded and smiled in meetings. Now Beré expresses astonishment at how aggressively everyone argues over decisions. "There is no way to genuinely give motivation to people unless they see that through their own efforts they will get a return."

Beré has also learned that patience isn't always rewarded. He once decided not to close a plant until employees near retirement had left. He's now convinced it would have been better to pay them to retire. "I thought I was doing them a favor," he says. "The problem was, we let time take care of too many things. Our strategy became the ideal model for a raider."

With the divestitures over, Beré's next challenge is to develop a strategy of more targeted growth. In a joint venture, he is establishing an Italian and South Korean automotive business. He has also acquired a domestic engine-component business and is looking for more automotive acquisitions. "We're going to be one of the survivors in the world markets because we've learned to think differently," he says. ■

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